Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Craig A. Leeker, Case Manager 1111
Examination Division, CT/RI District

from: Assistant District Counsel, New England District, Boston

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subject: **Investment Tax Credit - Transition Property**
[redacted]

U.I.L. 49.05-04 R90; 49.05-08 R90

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This responds to your memorandum dated November 24, 1999, in which you requested advice concerning the investment tax credit transition rule.

Facts

The taxpayer has filed a refund claim for approximately $[redacted] of investment tax credits for its [redacted] (calendar) tax years. The credits are claimed under three transition rules in the Tax Reform Act of 1986 ("1986 Act"): the supply or service contract transition rule, the equipped building rule, and the self-constructed property rule. Based on Attachment 1 of your November 24th submission, it appears that the bulk, approximately $[redacted], of the claim is made under the supply or service contract transition rule.

The supply or service contract claims[1] have been made under [redacted] contracts for the manufacture by the taxpayer of [redacted]. [redacted] of these [redacted] contracts were commercial contracts, and [redacted] were government contracts. The contracts overview submitted by the taxpayer in making the claim for refund contains the following information.[2]

1) The [redacted] contract was executed on [redacted]. No specific quantities of [redacted] were stated, but the taxpayer agreed, given sufficient lead time, to provide the necessary number of [redacted] to meet the purchaser's requirements.

2) The [redacted] contract was entered into on [redacted], and effective until [redacted]. It was automatically renewable on an annual basis unless either party provided notice of cancellation 90 days prior to the end of the calendar year. The contract did not provide the number of [redacted] to be delivered by the taxpayer; rather,

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[1] You have treated the [redacted] production contracts as supply or service contracts in considering the taxpayer's claim for refund. [redacted], (b)(5)(AC) (b)(5)(AC) [redacted].

[2] Your memorandum of November 24th states that the [redacted] contracts specify the quantity of products to be delivered, and refers to attachments 4, 5 and 8 on this point. Attachment 4 is a copy of the first and last pages of the [redacted] contract between the taxpayer and [redacted], dated [redacted], and several additional pages including a cover sheet entitled Amendment No. 1 to the [redacted] contract. The date of the amendment is not indicated. Attachment 5 contains two pages from the [redacted] contract between a subsidiary of the taxpayer and [redacted]. (You have not raised with us, and we do not address, the issue whether an entity related to a party to a binding contract could claim relief under the transition rules based on the binding contract.) The cover sheet is dated [redacted], and the signature page is dated [redacted]. Also included in Attachment 5 is what appears to be a purchase order from [redacted] to the taxpayer, dated [redacted], with a note stating that the customer's option will be indicated at a later date. Attachment 8 contains contract excerpts from the [redacted] contract between the [redacted] and the taxpayer, signed by the contracting officer on [redacted], and includes a performance schedule. We cannot confirm from the exhibits that the quantities to be delivered were specified in the contracts.

purchase order unless the purchase order materially modified the terms of the contract.

3) The [redacted] contract was an agreement made on [redacted]. The quantity of deliverables was not specified in the contract; instead, specific quantities were determined by purchase orders issued pursuant to the terms of the contract. The taxpayer was obligated to accept purchase orders conforming to the provisions of the contract.

4) The [redacted] contract was executed on [redacted]. As with the other commercial contracts, the quantity of [redacted] was not stated in the primary contract, but was instead determined by purchase orders issued by the purchaser pursuant to the terms of the contract.

5) The [redacted] contract was executed on [redacted]. The quantity and delivery schedules for the [redacted] were not specified in the contract, but were instead to be determined by purchase order. The taxpayer was obligated to fulfill purchase orders that conformed to the provisions of the contract.

6) The [redacted] contract was executed in [redacted] between the taxpayer and [redacted] other collaborators. The quantity and delivery schedule for the [redacted] was not specified in the agreement.

7) The [redacted] were produced for the [redacted] and several [redacted] countries, pursuant to a Memorandum of Understanding signed in [redacted]. Additional [redacted] were produced for [redacted] purchased by other [redacted]. Deliveries extended through [redacted].

8) The [redacted] was qualified by the [redacted] in [redacted], and production began later the same year. Full operational services for the [redacted] and the [redacted] began in [redacted] and [redacted] respectively.

9) The [redacted] was produced beginning in [redacted] and continuing through late [redacted]. Production of the [redacted] began in [redacted] and continued through [redacted].

10) The [redacted] contract was awarded to the taxpayer as a second source provider contract. The taxpayer produced the [redacted] for [redacted] years under the contract.

Your memorandum of November 24th states that the [redacted] contracts in issue do not specify the equipment needed to fulfill them, but they do specify the products to be delivered. Thus, the equipment for which the investment credit is now claimed is not specifically identified in the [redacted] contracts. Your memorandum indicates that the taxpayer relies for its refund claim on the descriptions in the contract of the product to be delivered, and on certain internal taxpayer documents called [redacted] ("[redacted]") that were signed a year or more after the original contracts. The [redacted] and their attachments specify equipment that is to be acquired, and make reference to the products to be produced with the equipment.

Issues

1) Were the [redacted] production contracts binding on December 31, 1985?

2) If the [redacted] production contracts are supply or service contracts under section 204(a)(3), was the production equipment for which the investment tax credit is claimed readily identifiable with and necessary to carry out the contracts?

Conclusions

1) Based on the taxpayer's description of the commercial [redacted] contracts, which indicates that the primary contracts did not specify the number of [redacted] to be produced, purchase orders rather than the [redacted] contracts would have to be tested under the supply or service contract rule, if applicable. The government contracts should likewise be examined to determine when the obligation to produce a certain number of [redacted] became fixed.

2) The production equipment was readily identifiable with and necessary to carry out the [redacted] contracts only if it was expressly specified in the contracts or related documents. Internal corporate documents are not considered related documents for this purpose. Based on the facts you have described, we conclude that the equipment on which the taxpayer has made a claim for refund was not readily identifiable with and necessary to carry out the [redacted] contracts.

Discussion

The general effective date for the repeal of the regular investment tax credit (ITC), located in section 211(e)(1) of the 1986 Act, was for property placed in service after December 31, 1985, in taxable years ending after that date. Former

section 49(b)(1) contained an exception for transition property, as defined in former section 49(e). Former section 49(e)(1) defined transition property as any property placed in service after December 31, 1985, and to which the amendments made by section 201 of the 1986 Act (repealing ACRS) did not apply, substituting in sections 203(b)(1) and 204(a)(3) (which contained the ACRS transition rules) a binding contract deadline of December 31, 1985. Section 204(a)(3) provided that the amendments made by section 201 shall not apply to any property which is readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease, which was binding on March 1, 1986.[3]

The [redacted] contracts as binding contracts

The legislative history of the 1986 Act provides that "the general binding contract rule does not apply to supply agreements with manufacturers, where such contracts fail to specify the amount or design specifications of property to be purchased; such contracts are not to be treated as binding contracts until purchase orders are actually placed." 2 H.R. Conf. Rep. No. 841, at II-55 to II-56, reprinted in 1986-3 C.B., vol. 4, 1, 55-56; General Explanation of the Tax Reform Act of 1986 ("Blue Book"), at 113 (Comm. Print 1987). Based on the information provided by the taxpayer in the refund claim, that the number of [redacted] to be delivered under the commercial contracts was not specified in the contracts, the commercial contracts themselves would not have been binding contracts under the general binding contract rule of section 203(b)(1)(A). Similarly, based on information provided by that taxpayer, the commercial [redacted] contracts would not have been binding contracts under section 204(a)(3), even assuming a contract for the manufacture of [redacted] could qualify as a supply or service contract. See 2 H.R. Conf. Rep. No. 84, at II-60; Blue Book at 118.

Instead, the taxpayer must identify purchase orders that were binding under the [redacted] contracts as of December 31, 1985,

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[3] Section 203(b)(2) of the 1986 Act generally provided that property with a class life of less than 7 years would not get transition relief. It also prescribed the date by which property of a certain class must be placed in service to qualify for transition relief. Section 49(e)(1)(C) permitted property with a class life of less than 7 years to qualify for ITC transition relief, but required that property with a class life of less than 5 years be placed in service by July 1, 1986, and property with a class life of at least 5 but less than 7 years be placed in service by January 1, 1987.

and show that the property for which the credit is sought was readily identifiable with and necessary to carry out the binding contract considered formed by submission of the purchase order. If property satisfied those conditions, but was also used for other purposes, including to fulfill purchase orders that were not binding on December 31, 1985, only an allocable portion of its cost may be eligible for transition relief.

The contract summary provided by the taxpayer does not indicate whether the government [redacted] contracts provided for the amount of [redacted] to be delivered. We cannot determine based on Attachment 8 that the [redacted] contract was a binding contract and that the number [redacted] to be delivered were specified in the contract. It is possible that the government contracts extended beyond one year,[4] but the contracts should be carefully scrutinized to determine whether they were multi year contracts, and if so, for what segments of the [redacted] programs they were multi year.

The "readily identifiable with" test

The following discussion of the readily identifiable test assumes that the [redacted] contracts are supply or service contracts. According to the legislative history, for property to qualify for transition relief as readily identifiable with and necessary to carry out a binding contract, both the specification and amount of property must be readily ascertainable from the terms of the contract and related documents. See 2 H.R. Conf. Rep. No. 841, at II-60; S. Rep. No. 313, at 112; H.R. No. 426, at 165; Blue Book at 118.

The courts in United States v. Ziegler Coal Holding Co., 934 F. Supp. 292 (S. D. Ill. 1996), Bell Atlantic Corp. v. United States, 99-1 USTC ¶ 50,119 (E.D. Pa. 1998), judgment vacated, 1999 U.S. Dist. LEXIS 2057 (Feb. 2, 1999), and Southern Multi-Media Communications, Inc., 113 T.C. No. 27 (Dec. 8, 1999), have interpreted the term "readily identifiable with" to the contrary.

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[4]The Anti-Deficiency Act generally prohibits a federal agency from making contracts in advance of appropriations. The Armed Services Procurement Act was amended in 1982 to encourage the Department of Defense to use multiyear contracts under the eye of Congress. Congress had to be notified if the cancellation ceiling in a contract exceeded $100 million, and further restrictions have been included in Department of Defense authorization and appropriation acts. See John Cibinic, Jr. and Ralph C. Nash, Jr., Formation of Government Contracts 1213-15(3d ed. 1998).

They have agreed with the government's position that property is readily identifiable with a contract only if it is expressly described in the contract or related documents. It is our understanding that this narrow interpretation remains the position of the Service, and you should follow it in considering the taxpayer's claim for refund. Accordingly, if the contracts or the relevant purchase orders do not specify the equipment needed to complete the contracts, the taxpayer is not eligible for transition relief on the equipment.

In United States v. Commonwealth Energy Systems, 49 F. Supp. 2d 57 (D. Mass. 1999), the taxpayer claimed transition relief from repeal of the investment tax credit for capital additions to a power plant. The court rejected the government's argument that relief was only available if the property had been explicitly referred to in the contract or related documents. The court concluded that property could be readily identifiable with a contract if the need for it could be inferred from the requirements of the contract. On January 20, 2000, an appeal on this issue was docketed (No. 97-11722, 1st Cir.).

In your request you noted that the taxpayer relies heavily in its refund claim on "[redacted]" ([redacted]), which are internal corporate documents. A taxpayer's internal documents are not considered related documents in the sense in which the term is used in the legislative history. See Bell Atlantic Corp., 99-1 USTC ¶ 50,119, at 87,034. They are not relevant in determining whether the taxpayer's property was readily identifiable with the [redacted] contracts.[5]

If we can be of further assistance in reviewing the contracts or otherwise, please let us know.

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[5]You pointed out that [redacted] were executed a year or more after the original contracts with which they are associated were signed. Were the [redacted] relevant to determining whether property was readily identifiable with binding contracts, and assuming that the [redacted] contracts themselves do not provide for the number of [redacted] to be delivered, the relevant date would be the date when the purchase orders were binding. As discussed in the text, the [redacted] are not relevant.